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SUBJECT: RESPONSE: IMPACT OF RISING FOOD/COMMODITY PRICES - BRAZIL

REF: A) SAO PAULO 199, B) SAO PAULO 23, C) SAO PAULO 227

SENSITIVE BUT UNCLASSIFIED

¶1. (U) THIS CABLE IS SENSITIVE BUT UNCLASSIFIED AND NOT FOR INTERNET DISTRIBUTION.

¶2. (SBU) Summary. Below is Post's response to STATE 39410 regarding the impact of rising food and commodity prices on Brazil. As Brazil is a significant net agricultural exporter, high international commodity prices have been beneficial. At the same time, higher domestic agriculture prices are contributing to increasing inflation, but have not had a significant impact on Brazil's economic and political stability. Agricultural producers continue to seek ways to reap the most benefit from these high prices, but expansion opportunities are somewhat constrained by a high rural debt burden and a weak transportation infrastructure.

DEMAND

¶3. (SBU) Half of the 4 percent inflation that Brazil has seen in the past 12 months was a result of the increase in food prices. Food and beverages represent 21 percent of the average Brazilian household's consumption. The most important commodities are rice, beans, wheat, chicken, beef, manioc flour, sugar and soybean oil. The average cost of the food basket has increased approximately 13 percent in the last year. The most significant price changes were seen in dry beans (70 percent), soybean oil (57 percent), beef (22 percent) and wheat flour (21 percent).

¶4. (SBU) Brazilian consumption of chicken, manioc flour and soybean oil is entirely supplied by domestic production. Domestic beef, dry beans and rice production supply 99, 95 and 90 percent of domestic consumption, respectively. However, domestic production of wheat supplies only 37 percent of consumption. Although the impact of high prices is stronger on the poor and urban groups, mostly in the less developed regions of Brazil, such as the Northeast, higher prices have not resulted in a noticeable shift in consumption towards alternative commodities. Incomes in the Northeast continue to rise, leading to a decline in the consumption of rice in favor of bread and animal proteins.

SUPPLY

¶5. (SBU) Brazil is a significant net agricultural exporter (approximately US\$40 billion in 2007), and agribusiness exports account for nearly a third of Brazil's total exports. In the basic commodities, Brazil is a net exporter of beef, chicken and soybean oil. It is self-sufficient in rice, dry beans and manioc flour, but

it is the world's largest importer of wheat.

¶16. (SBU) As a result of higher prices, agricultural production is increasing slightly. As indicated in the recent FAS grain annual report (and soon to be indicated in the FAS soybean annual report), farmers are responding to high international prices by seeking to maximize production, and both Brazilian and multinational companies are expanding production capacity. However, potential expansion is constrained by farmers' heavy credit burden carried over from several years ago and the significant problems with transportation infrastructure.

¶17. (SBU) There has been no shift in production between food and non-food commodities such as biofuels. Brazil utilizes sugar cane for fuel, not food crops. Sugar cane accounts for only one percent of total cultivated land for crops. High international prices of such commodities as soybeans and cotton are discouraging the use of those commodities for biofuels.

¶18. (SBU) The price of agricultural inputs has risen significantly in Brazil. Land prices have increased with the price of commodities. The price of seeds, chemicals and irrigation equipment increased slightly. Water and labor costs have not increased. The most significant increase has been in the price of fertilizer. Fertilizer prices rose between 35 and 50 percent last year, and are expected to do the same this year. The average price of two of the most common fertilizers used in growing soybeans increased around 300 percent between January 2007 and April 2008. Potassium chloride, the most common potassium fertilizer, also known as potash, rose 190 percent in the same period. Increasing fertilizer prices have caused nervous farmers to start buying fertilizer earlier than normal in order to hedge against rising prices.

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¶19. (SBU) A shortage of storage capacity contributes to some crop loss. Poor infrastructure, such as bad roads, limited port facilities, and a lack of railroads or the ability to transport via waterway, provides significant impediments to expanding production and exports. Despite these difficulties, Brazil remains the world's third largest agricultural exporter.

POLITICAL IMPACT

¶10. (SBU) There have been no public protests, violence, class conflict, or other activities that would impact the stability of the Brazilian government as a result of high food prices. As Brazil is a leader in biofuels technology, research, consumption and marketing, the government and the general public strongly support and defend the use of biofuels. Brazil's political leaders see the growing world demand for agricultural products as being positive, and they view Brazil as a key part to solving this problem. To date, the concerns over domestic price increases and inflation have been relatively modest.

ECONOMIC IMPACT

¶11. (SBU) Rural households in the Amazon are mostly self-sustainable small farms. They rarely suffer from food shortages and are not expected to be impacted by rising food prices. In rural northeastern Brazil, food prices and local staple crops are highly dependent on weather patterns. At the moment, much of northeastern Brazil is suffering from unusually heavy rains, which although they are causing severe local flooding, are expected to result in better than usual crops. However, rising food prices in poor cities and towns in Brazil's Northeast may cause localized problems for individuals outside the government safety net programs - a situation that deserves monitoring.

ENVIRONMENTAL IMPACT

¶12. (SBU) The rate of deforestation of the Amazon closely tracks the increase in commodity prices. In the last five months, the government has reported a sharp increase in the deforestation rate, reversing a declining trend in the prior four years. There is little evidence that cultivation of staple food crops in Brazil

(rice, dry beans, cassava, small-scale corn production) is a major driver of deforestation. In addition, informal or illegal land clearing often takes place on Brazil's Amazon frontiers, as squatters occupy areas devoid of effective environmental enforcement. These illegal practices are not associated with cultivation of staple crops in Brazil.

GOVERNMENT POLICY RESPONSE

¶13. (SBU) As a result of high commodity prices and Argentina's export restrictions, the GOB eliminated the import tariff for up to 1 million metric tons (mt) of wheat imported before June 30, 2008. Industry is asking for the time limit to be extended and the amount increased. The United States and Canada will be the primary sources of this wheat. In addition, the GOB has declared that it wants Brazil to double its wheat production by 2012. A plan for how this will be accomplished is supposed to be released before the end of the year.

¶14. (SBU) On April 23, the Brazilian Minister of Agriculture announced that, for the next six to eight months, the government would block the export of the one million mt (milled equivalent) of rice currently in government stocks and would encourage the private sector to not export rice. Following a meeting with the rice sector the following day, the Minister confirmed that Brazil has enough rice in public and private stocks to not need to block exports of privately-held rice. Brazil's demonstrated willingness to interfere in the market has contributed to a nervous international market and reportedly has led to embarrassment on the part of Brazilian negotiators in Geneva.

¶15. (SBU) Brazil's central bank is responding to the inflationary pressure through more restrictive monetary policy. On April 16, 2008, Brazil raised its benchmark (SELIC) rate from 11.25 percent to 11.75 percent in effort to control inflation. Over the next year, the central bank is expected to raise its overnight interest rate by roughly 1.0 to 1.5 percentage points. Not all of this increase can be attributed to food inflation, but the central bank has cited food

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inflation as one significant factor that is affecting its decision-making.

¶16. (SBU) In light of the increase in deforestation, the Brazilian authorities have stepped up efforts to enforce laws protecting the Amazon. However, they are unlikely to solve the problem given the magnitude of the Amazon. Although Brazil has made no changes in its biotech or SPS policies as a result of high commodity prices, Brazil has taken the opportunity to renew its public calls for an end to agricultural subsidies in developed countries. President Lula recently has said that agricultural subsidies and corn-based ethanol are to blame for the high food prices, while sugar-based ethanol is not.

IMPACT ON POST PROGRAMS

¶17. (SBU) As part of our partnership under the bilateral biofuels MOU, we have agreed to work jointly to address public criticism of ethanol production. Secretary Rice and Brazilian Chief of Staff Dilma Rouseff have agreed to create a sustainability task force, and post will hold a biofuels seminar in September, in part to discuss countering the criticism that biofuels contribute to high prices.

PUBLIC PROPOSALS

¶18. (SBU) We have responded positively to Brazil's suggestion that we work together to address the food/energy issue and would advocate continued efforts to analyze and respond to the criticisms on a factual level. Also, working jointly to develop the next-generation of biofuels will help decrease any perception that the ethanol market has an impact on food prices. In the long term, efforts to improve the investment climate, such as negotiating bilateral investment treaties and tax treaties with the U.S., as well as streamlining bureaucratic hurdles to investment, would open opportunities for investors to participate in the development of Brazilian infrastructure, thereby reducing the cost of bringing products to market.

